

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF RATES IN THE	)	
EAST LOGAN WATER DISTRICT AND	)	
FOR AUTHORITY TO REAMORTIZE	)	CASE NO. 9440
EXISTING BOND INDEBTEDNESS	)	

O R D E R

On October 4, 1985, East Logan Water District ("East Logan") filed an application to increase rates and for authority to reamortize its existing indebtedness. The increase requested would produce additional revenues of approximately \$43,790 annually, an increase of 26.78 percent over test-period actual operating revenues.

East Logan's application was accompanied by a motion seeking emergency rate relief pursuant to KRS 278.190(2). This interim request was denied on November 8, 1985, because of numerous deficiencies in both the general and interim rate applications.

East Logan is a non-profit water utility engaged in the distribution and sale of water to approximately 760 customers in Logan County, Kentucky. A hearing was held on March 24, 1986, in Frankfort. The decision of the Commission is based on information contained in the application, written submissions, the staff audit report, annual reports, responses to hearing questions and other documents on file in the Commission offices. After the adjustments and determination herein, East Logan is granted authority to

increase rates to produce additional operating revenue of \$23,193 or 14.18 percent.

#### REAMORTIZATION OF EXISTING BOND INDEBTEDNESS

East Logan is seeking authority to reamortize its existing bond indebtedness with the Farmer's Home Administration ("FmHA"). East Logan is approximately \$54,000 in arrears and is attempting to refinance approximately \$952,000 with FmHA.<sup>1</sup> However, East Logan was unable to provide evidence that FmHA had agreed to this financing plan. In fact, at the public hearing East Logan stated that FmHA will not reamortize the loan until there is adequate cash flow and will not reamortize until the Commission recommends or grants a rate increase.<sup>2</sup>

The Commission is concerned with East Logan's financial stability, but finds that East Logan has not presented sufficient information in this matter. Further, East Logan's hearing statement concerning the status of the reamortization indicates that FmHA will not consider reamortization until the resolution of this case. Therefore, the Commission hereby denies East Logan's request and will consider no aspects of the reamortization plan in its determination of the revenue requirements in this case.

#### Staff Audit Report

Because of the numerous filing deficiencies and in response to East Logan's request for staff assistance, the Commission staff

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<sup>1</sup> Response to Commission's Information Request dated February 13, 1986, Item No. 10.

<sup>2</sup> Hearing Transcript, March 24, 1986, pp. 30-31.

performed a limited financial audit for the utility's test period to verify reported expenditures and substantiate the propriety of the test-year financial statements. Based upon the findings in the staff report, adjustments were made to test year operations to reflect a net loss of \$50,601. The staff audit report was made a part of the record in this case on March 7, 1986.

#### REVENUES AND EXPENSES

East Logan proposed, and the Commission accepts, the 12-month period ending June 30, 1985, as an appropriate test period for determining the reasonableness of the proposed rates.

The Commission has made, for rate-making purposes, the following modifications to test period expenses to reflect more normal and current operating conditions:

##### Operating Revenues

A billing analysis performed by the Commission staff showed test-period operating revenue from water sales of \$162,056, uncollectibles of \$1,472 and \$5,171 in utility tax collections. East Logan collects a 3 percent utility tax as a collection agency for the public schools. This item is not revenue to the utility, and should be carried on the balance sheet rather than the income statement. This results in a decrease of \$5,198 to the \$168,725 test-period operating revenues.

##### Depreciation Expense

East Logan depreciates transmission and distribution plant over useful lives of from 37 to 40 years. The Commission has determined that East Logan's transmission and distribution mains should be depreciated consistently over a useful life of 40 years

from the date of service. In addition, East Logan, except for items capitalized as a result of the staff audit, has recorded plant additions as transmission and distribution mains. East Logan is hereby notified that it should reclassify plant-in-service to the appropriate services, meters, meter installations and hydrant accounts.

Depreciation expense has been increased by \$3,850 to a level of \$54,713. This amount includes depreciation on test-year-end distribution reservoirs and standpipes, and transmission and distribution mains over a useful life of 40 years (an annual rate of 2.5 percent) plus annual depreciation on the services, meters and meter installations capitalized as required in the staff audit report.

East Logan's proposed depreciation expense for the test year includes depreciation on contributed property. The Commission finds it unfair to have customers pay depreciation on assets acquired with contributed funds. We have adjusted depreciation expense to exclude \$30,680<sup>3</sup> attributable to utility property which was acquired at no cost through contribution from customers or federal grant.

<sup>3</sup>	Contributed Plant--Reported	\$1,210,780
	Additions--Staff Audit Report	19,505
	Total Contributed Plant	<u>\$1,230,285</u>
	Composite Depreciation Rate (Test-Year	
	Depreciation Exp./Plant-in-Service	<u>2.493768</u>
	Depreciation on Contributed Property	<u>\$ 30,680</u>

### Purchased Water Expense

According to the 1984 Annual Report, East Logan experienced a water loss (unaccounted-for water) of 29.81 percent. The 1985 Annual Report showed an increase in this item to 33.69 percent. The Commission is of the opinion that, for rate-making purposes, water loss should be limited to 15 percent. Therefore, purchased water expense allowed for rate-making purposes has been reduced to \$49,635.<sup>4</sup>

### Outside Services

Outside services has been increased as a result of two adjustments. Management expense was increased by \$1,060 to a level of \$31,920. This adjustment was determined by annualizing East Logan's monthly subscriber fee of \$3.50 to 760 test-year-end subscribers. Additionally, East Logan expensed the \$544 cost of a customer survey. The Commission, for rate-making purposes, will allow East Logan to amortize this expense over a 3-year period. This allows an annual charge of approximately \$181. The combined effect of these adjustments results in an increase of \$697 to outside services.

### Taxes

East Logan's "tax expense" has been decreased by \$4,533. This amount represents the 3 percent utility tax collected from

<sup>4</sup>	Gallons of Water Sold	43,050,780
	DIVIDE	.85
	Gallons at 15% Loss	50,647,976
	Rate	\$ .00098
	ALLOWANCE	\$ 49,635

customers and paid over to the Logan County School District and the Russellville Independent School District. This collection by East Logan represents neither income nor expense and, as such, has not been included in the adjusted operating statement contained herein.

#### Interest Expense

East Logan, with the assistance of FmHA, borrowed \$100,000 from Citizen's National Bank of Russellville ("Citizen's") during the test period, to pay past due accounts, complete a construction project and to repay a previous debt to the lending institution.<sup>5</sup> East Logan stated that FmHA maintains that Commission approval was given for this loan; however, no application was filed and there are no documents on file with the Commission supporting this contention.

East Logan has clearly documented that \$27,590 of the loan was used for the Stevenson Mill Road Construction Project ("SMRC Project") and that the remainder was used to pay operating expenses. The Commission is of the opinion that, in determining East Logan's rates, the allowance of interest on the \$72,410 used for operating expenses is generally improper and inappropriate in that it would constitute retroactive rate-making. Although the Commission has excluded that portion of East Logan's interest expense, the Commission wishes to point out that the revenues allowed in this case will provide sufficient cash flow to allow East Logan to pay the debt service on this note.

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<sup>5</sup> Response to Commission's Information Request dated February 13, 1986, Item No. 11.

Therefore, East Logan's interest expense, for rate-making purposes, has been decreased by \$10,912. This adjustment was determined by applying the 5 percent interest rate to the schedule of FmHA bond maturities as shown in the annual reports and by applying the current interest rate to \$27,590 of the \$100,000 loan with Citizen's. In this manner the Commission has determined that interest due and payable for rate-making purposes is \$47,604.

After consideration of the aforementioned adjustments, the Commission finds East Logan's test period operations to be as follows:

	<u>Test Period Per Staff Audit</u>	<u>Adjustments</u>	<u>Adjusted Test Period</u>
Operating Revenues	\$168,725	\$ <5,198>	\$163,527
Operating Expenses	<u>163,382</u>	<u>&lt;34,850&gt;</u>	<u>128,532</u>
Net Operating Income	\$ 5,343	\$ 29,652	\$ 34,995
Interest Income	2,572	-0-	2,572
Interest on Long-Term Debt	<u>58,516</u>	<u>&lt;10,912&gt;</u>	<u>47,604</u>
NET INCOME	<u>\$&lt;50,601&gt;</u>	<u>\$ 40,564</u>	<u>\$&lt;10,037&gt;</u>

#### REVENUE REQUIREMENTS

The Commission is of the opinion that the rates producing the adjusted test-period operating loss are clearly unfair, unjust and unreasonable. The Commission finds the Debt Service Coverage ("DSC") method to be an appropriate method of determining revenue requirements in this case and adequate to allow East Logan to pay its operating expenses, meet its debt service requirements and maintain a reasonable surplus.

The Commission has applied a 1.2X DSC to the scheduled average principle and interest payments on the FmHA bonds due

within the next 5 years. Approval for the execution of the \$100,000 note was not obtained from the Commission as required by KRS 278.300 and this has been excluded from "debt-service" for computation of allowable coverage.

Using a DSC of 1.2X plus operating expenses and the interest associated with the SMRC Project, the Commission finds East Logan's total revenue requirement to be \$189,292<sup>6</sup> and that an increase in annual revenue of \$23,193<sup>7</sup> will be sufficient.

East Logan indicated that the requested increase was based on cash flow.<sup>8</sup> A cash flow analysis, in which non-cash items such as allowable depreciation plus amortization expense are added back, indicates that with the rates herein allowed, East Logan

<sup>6</sup>	Staff Adjusted Test-Year Operating Expenses	\$ 128,532
	Construction Project Interest Allowed	2,704
	Subtotal	<u>\$ 131,236</u>
	ADD:	
	5-Year Average Principle & Interest Requirements	48,380
	.2 Coverage of Principle & Interest Requirements	<u>9,676</u>
	TOTAL REVENUE REQUIREMENT	<u><u>\$ 189,292</u></u>
<sup>7</sup>	Total Revenue Requirement	\$ 189,292
	LESS:	
	Uncollectibles	<1,471>
	Interest Income	<u>&lt;2,572&gt;</u>
	Revenue Required from Sales of Water	\$ 185,249
	LESS:	
	Test Period Revenues from Sales of Water	<u>&lt;162,056&gt;</u>
	AMOUNT OF INCREASE ALLOWED	<u><u>\$ 23,193</u></u>

<sup>8</sup> Hearing Transcript, March 24, 1986, p. 30.



should have approximately \$13,358<sup>9</sup> available annually. The Commission is of the opinion and finds that the revenue granted herein will produce gross annual revenue sufficient to pay East Logan's operation expenses, service its debt and provide a reasonable surplus.

#### RATE DESIGN

East Logan proposed a rate of \$3.30 per 1,000 gallons for usage between 6,000 and 10,000 gallons, and a rate of \$1.90 per 1,000 gallons for all usage in excess of 10,000 gallons.

After reviewing East Logan's current and proposed rate design and its cost of providing service, the Commission has increased the rate for usage between 6,000 and 10,000 gallons to \$3.50 per 1,000 gallons and granted the proposed rate of \$1.90 per 1,000 gallons for all usage over 10,000 gallons. The Commission is of the opinion that these rates more adequately reflect the actual cost of providing service.

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<p><sup>9</sup> Adjusted Net Operating Income</p> <p>ADD:</p> <p>Revenue Increase Allowed</p> <p>Interest Income</p> <p>Non-Cash Expense: Allowable Depreciation Expense</p> <p>Amortization Expense</p> <p>Subtotal</p> <p>DEDUCT:</p> <p>Depreciation Sinking Fund</p> <p>Interest on Arrearages @ 5%</p> <p>Disallowed Purchased Water Expense</p> <p>5-Year Average FmHA Principle &amp; Interest Requirements</p> <p>Citizen's Principle &amp; Interest Requirements</p> <p>TOTAL CASH AVAILABLE</p>	<p>\$ 34,995</p> <p>23,193</p> <p>2,572</p> <p>24,033</p> <p><u>1,978</u></p> <p>\$ 86,771</p> <p>5,400</p> <p>2,700</p> <p>4,184</p> <p>48,380</p> <p><u>12,749</u></p> <p><u>\$ 13,358</u></p>
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### OTHER ISSUES

The Commission is concerned about the current status of East Logan's operations. The inaccuracies and errors revealed in the staff audit report resulted in the inability of East Logan to present a true picture of its operations. In addition, East Logan's lack of knowledge concerning the rules and regulations of the Commission have led to decisions by East Logan that are not in compliance with these rules and regulations.

It is evident that the present commissioners of East Logan inherited numerous financial, managerial and operational problems. Adequate financial records had not been maintained, the former chairman of East Logan was at the same time the manager of the District and water line loss is, and has been, approximately 30 percent. The Commission recognizes that East Logan is aware of past deficiencies; however, the Commission wishes to inform East Logan that deficiencies in the following areas must be addressed immediately:

#### Conformity with Commission Rules and Regulations

The information upon which a rate decision is based must conform with known and measurable standards. East Logan's application was deficient to such an extent that the processing of this application was needlessly delayed. The reamortization plan, for which Commission approval was requested, has not been formally approved by FmHA. For consideration in any future rate adjustment proceedings, all information must be adequately documented, verified and justified, and must be submitted in accordance with the requirements as set forth by this Commission.

In addition, East Logan has undertaken construction and secured long-term financing without obtaining Commission approval as required. In this case, interest on funds secured to pay prior operating expenses have been disallowed. East Logan is cautioned that, in the future, deviations from Commission rules and regulations may result in further exclusions from the determination of revenue requirements.

#### Excessive Water Loss

The reduction of unaccounted-for water from more than 30 percent to an acceptable level of 15 percent should be East Logan's highest operational priority. The Commission has allowed water districts in some instances to recover the cost of excessive line loss through rates where the district has an approved plan to use the money to reduce line loss. East Logan should investigate the appropriateness of requesting inclusion in the Commission's Water Demonstration Project.<sup>10</sup>

#### Maintenance of Financial Information

East Logan did not apply for a rate increase until October 1985, when it was apparent as early as May 1984 that financial assistance was needed. The failure to maintain timely and accurate financial information in accordance with the Uniform System of Accounts for Water Utilities ("Uniform System of Accounts") has seriously eroded East Logan's financial position as evidenced by the securing of the loan with Citizen's to pay prior

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<sup>10</sup> Public Service Commission Announcement dated April 18, 1983, A Demonstration Project to Define Excessive Water Loss.

operating expenses and by East Logan's failure to meet the debt requirements of the FmHA bond. East Logan is directed to begin financial record-keeping in accordance with the Uniform System of Accounts.

#### Evidence of Mismanagement

In reference to an investigation by the United States Department of Agriculture ("Department of Agriculture"), the minutes of the April 25, 1985, board meeting state that there was evidence of mismanagement in the amount of \$90,000. However, in testimony at the public hearing, East Logan stated that the investigation by the Department of Agriculture made no determination of mismanagement and that the District has not received any report indicating the findings.<sup>11</sup> East Logan is to submit a formal report concerning this matter to the Commission within 60 days of the date of this Order. This report should clearly explain the reasons for requesting any investigations, who performed investigations and any reports, written or oral, received by East Logan. East Logan is to include comments concerning the reference in the minutes to the \$90,000, what attempts the District has made to recoup these funds and thoroughly explain the present position of East Logan in this matter.

#### Management Contract

The Commission is concerned with the possibility of conflict of interest and commingling of operations under the terms

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<sup>11</sup> Hearing Transcript, March 24, 1986, p. 25.

of the current management contract. East Logan should review the present contract and institute controls necessary to insure that the management company acts, at all times, in the best interests of the District.

The Commission wishes to commend the current board of commissioners for its efforts to correct East Logan's deficiencies. East Logan's management has requested and received assistance from the Commission's Financial Audit Section in restructuring the accounting system in accordance with the Uniform System of Accounts. While East Logan has made progress, the board of commissioners is hereby notified that failure to improve in the areas mentioned above could seriously jeopardize the operations of the District.

#### SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. The rates proposed by East Logan would produce revenue in excess of that found reasonable herein and therefore, should be denied upon application of KRS 278.030.

2. The rates in Appendix A are the fair, just and reasonable rates for East Logan in that they are calculated to produce gross annual revenue from water sales of \$185,249. These revenues will be sufficient to meet East Logan's operating expenses found reasonable for rate-making purposes, service its debt and provide a reasonable surplus.

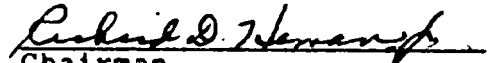
3. East Logan's reamortization plan has not been sufficiently documented or finalized and should be denied.

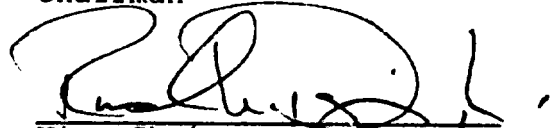
IT IS THEREFORE ORDERED that:

1. The rates proposed by East Logan are denied.
2. The rates and charges in Appendix A are approved for service rendered by East Logan effective on and after the date of this Order.
3. Within 30 days from the date of this Order, East Logan shall file with this Commission its revised tariff sheets setting out the rates approved herein.
4. The reamortization plan proposed by East Logan shall be denied.
5. East Logan shall file, within 30 days from the date of this Order, a plan addressing the excessive water loss.
6. East Logan, retroactive to January 1, 1986, shall maintain its financial records in accordance with the Uniform System of Accounts.
7. East Logan shall file, within 60 days from the date of this Order, a report summarizing the reclassification of plant-in-service.
8. East Logan shall file, within 60 days from the date of this Order, a report outlining controls instituted to prevent conflict of interest or commingling of operations.
9. Within 60 days, East Logan shall file with this Commission a formal report, as outlined in this Order, concerning the question of mismanagement.

Done at Frankfort, Kentucky, this 15th day of May, 1986.

PUBLIC SERVICE COMMISSION

  
Chairman

  
Vice Chairman

  
Commissioner

ATTEST:

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Secretary

## APPENDIX A

### APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 9440 DATED MAY 15, 1986

The following rates and charges are prescribed for the customers in the area served by East Logan Water District. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

#### RATES: Monthly

##### 5/8 x 3/4 Inch Connection

First 2,000 gallons	\$9.95 Minimum Bill
Next 2,000 gallons	4.60 per 1,000 gallons
Next 2,000 gallons	4.35 per 1,000 gallons
Next 4,000 gallons	3.50 per 1,000 gallons
Over 10,000 gallons	1.90 per 1,000 gallons

##### 1 Inch Connection

First 4,000 gallons	\$19.15 Minimum Bill
Next 2,000 gallons	4.35 per 1,000 gallons
Next 4,000 gallons	3.50 per 1,000 gallons
Over 10,000 gallons	1.90 per 1,000 gallons

##### 1 1/2 Inch Connection

First 6,000 gallons	\$27.85 Minimum Bill
Next 4,000 gallons	3.50 per 1,000 gallons
Over 10,000 gallons	1.90 per 1,000 gallons

##### 2 Inch Connection

First 10,000 gallons	\$41.85 Minimum Bill
Over 10,000 gallons	1.90 per 1,000 gallons